

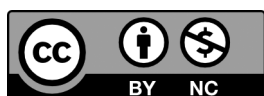
# The Performance Dilemma and Countermeasures of the Put Option Agreement under the New Company Law

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**Abstract:** As an important tool of equity financing, the put option agreement has played a key role in solving the financing problems of enterprises. However, its performance faces multiple legal predicaments under the framework of the new Company Law. The core of the put option agreement lies in balancing the interests of both investors and financiers through the valuation adjustment mechanism, but its effectiveness and performance have long been controversial. China's judicial practice has gone through three turning points, namely the "Haifu Case", the "Huagong Case", and the "Yinhaitong Case", gradually shifting from "negation of effectiveness" to "separation of effectiveness and performance", and ultimately focusing on the concretization of performance conditions. The "Nine People's Court Opinions" clearly defined the validity of the put option agreement, but by binding the equity repurchase with the capital reduction procedures, it led to prominent performance difficulties. Specifically, the equity repurchase of the target company needs to go through the capital reduction procedure, but the conflict of interests among shareholders makes the targeted capital reduction difficult to achieve. Cash compensation is restricted by the company's profit distribution rules and the shareholders' ability to fulfill their obligations, presenting a double obstacle. In response to the above problems, this paper proposes a solution approach combining "prevention in advance" and "relief after the fact". Pre-emptive prevention includes: strengthening information disclosure to safeguard creditors' right to know, avoiding procedural deadlocks through conditional capital reduction resolutions, and introducing third-party acquisition mechanisms to diversify risks. Post-event relief draws on the "solvency test" of the United States, with the balance sheet test, balanced solvency test, and significant asset insufficiency test as the core, to distinguish the company's performance ability from business risks and balance the interests of all parties.

**Key words:** Put option agreement; Performance dilemma; Equity repurchase; Cash compensation; Capital reduction procedure



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## 1 Introduction

The "put option agreement" is an important innovation in the field of equity financing and is of great significance for Chinese companies to solve the problem of difficult financing. A "put option agreement", also known as a valuation

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adjustment agreement, refers to an agreement reached by an investor and a financier when they reach an equity financing agreement, stipulating that the financier will adjust the investor's investment conditions or provide compensation to the investor based on the company's future operating conditions, such as whether it will go public within the next three years. The valuation adjustment methods mainly include equity repurchase and monetary compensation.<sup>1</sup> The "put option agreement" mainly includes: (1) The "put option" between the investor and the shareholders or actual controllers of the target company; (2) The "bet" between the investor and the target company; (3) Forms such as the investor simultaneously "betting" against the shareholders of the target company and the target company (Han Xue, 2024).

The put option agreements in our country have undergone three important turning points in judicial judgments. The three turning points of the put option agreement were respectively the "Haifu Case", the "Huagong Case", and the "Yinhaitong Case".

The "Haifu Case" involves a dispute over the validity of the performance compensation clause between Haifu Company (the investor) and Gansu Shihuan (the target company). In the judgment of this case, the Supreme People's Court established the judicial approach that "the bet between the investor and the shareholders of the target company is valid, but the bet with the target company is invalid." In the "Huagong Case", the Higher People's Court of Jiangsu Province clearly defined the judicial approach of "separation of validity and performance", and proposed that "when a limited liability company repurchases its shares after fulfilling the legal procedures, it will not harm the interests of the company's shareholders and creditors and does not violate the mandatory provisions of the law." In the "Silver Sea Pass Case", the Supreme People's Court detailed the conditions for the performance of the put option agreement, namely that the target company's repurchase must meet the legal circumstances of equity repurchase, shareholders are not allowed to withdraw their capital contributions, and there are restrictions on profit distribution. China's judicial adjudication has achieved a transformation from "determining the validity of the put option agreement" to "separating the validity and performance of the put option agreement", and then to "the conditions for the performance of the put option agreement" in terms of the adjudication approach of the put option agreement (Pan Lin, 2024).

In November 2019, the "Minutes of the National Court Civil and Commercial Trial Work Conference" (hereinafter referred to as the "Nine Civil Minutes") was issued. Article 5 of it distinguishes the validity and performance of contracts, confirms the validity of the put option agreement between the investor and the investment company, and at the same time regards "completing the capital reduction procedure" as a prerequisite for "fulfilling the put option repurchase". Before the release of the "Nine People's Court Opinions", it was generally believed that the target company, as the obligated subject of share repurchase, might lead to a reduction in the registered capital and net assets of the target company, thereby violating the principle of maintaining the company's capital and harming the interests of the company's creditors. However, the "Nine People's Court Opinions" clearly states that in the absence of any legal invalidity reasons, if the target company merely claims that the "put option agreement" is invalid on the grounds of share repurchase or monetary compensation, the people's court shall not support such claims. The above-mentioned judgment rules of the "Nine People's Court Opinions" clearly distinguish the validity of the put option agreement from the issue of its enforceability, and no longer take whether the contract can be actually performed and whether the actual performance will harm the interests of other interested parties as the criteria for judging the validity of the contract (Yi Xiaohui, 2024).

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<sup>1</sup> See Civil Ruling No. 2957 of 2020 of the Supreme People's Court.

## 2 Difficulties in the Performance of the Put Option Agreement

The performance of a put option agreement, in terms of form, includes the performance of equity transfer and the performance of cash compensation(Duan Xiaohong & PI Yuan, 2021).However, both forms of fulfillment are difficult to achieve in practice.

### 2.1 Equity Repurchase is Difficult to Implement Due to the Capital Reduction Procedures

Generally speaking, if the investor signs a put option agreement with the shareholders of the target company and stipulates the repurchase of equity, there will be no obstacles to capital reduction during the performance, and the investor can directly request the shareholders of the target company to contribute capital for repurchase. However, if the investor and the target company stipulate equity repurchase in the put option agreement, the investor's request for the target company to repurchase the equity must be subject to the company's capital reduction resolution; otherwise, it violates the principle of capital maintenance.

At the legal level, the target company's repurchase of equity must be premised on fulfilling the capital reduction procedures. Article 5 of the "Nine People's Court Opinions" clearly stipulates that "when an investor requests the target company to repurchase its equity, the people's court shall review it in accordance with the mandatory provisions of Article 53 of the new" Company Law "that 'shareholders shall not withdraw their capital contributions' or Article 169 regarding equity repurchase." Upon review, if the target company fails to complete the capital reduction procedures, the people's court shall reject its lawsuit request.

At the subject level, the interests of all parties related to the company are not consistent, making it difficult to carry out the capital reduction procedures. The situation where an investor requests the target company to repurchase its equity is usually when the company fails to go public successfully or fails to reach the agreed profit, etc. The investor loses confidence in the operation of the target company and wants to recover the invested funds. For the controlling shareholder, equity repurchases will lead to a reduction in the company's capital. Consequently, the actual controlled funds of the controlling shareholder will decrease, which is not conducive to the company's financing, production, and operation. For minority shareholders, the reduction in company capital caused by equity repurchases is highly likely to lead to a decrease in the company's stock price and a reduction in the market value of the stocks held by minority shareholders. Therefore, at this time, the investors are essentially in opposition to the interests of the company's shareholders. The capital reduction procedure carried out through equity repurchase in the put option agreement is actually a targeted capital reduction. This way of reducing capital will change the original equity structure, so strict legal procedures must be followed. According to the new Company Law, the targeted capital reduction in a limited liability company requires the unanimous consent of all shareholders, while the targeted capital reduction in a joint stock limited company requires the prior authorization of the company's articles of association. That is, in the Company Law, capital reduction must be approved by the shareholders' meeting. For a limited company, the resolution on capital reduction must be passed by shareholders representing more than two-thirds of the voting rights. For a joint stock company, the resolution on capital reduction must be passed by more than two-thirds of the voting rights held by the shareholders present at the meeting(He Jian, 2021). However, the interests of shareholders conflict with those of investors, making it difficult to reach a resolution on capital reduction.

## 2.2 Cash Compensation is Difficult to Achieve

According to the compensation subject stipulated in the put option agreement, it can be divided into the target company or the shareholders of the target company. When the compensation subject is the target company, it is difficult for investors to require the target company to fulfill the cash compensation (Ran Keping & Zhang Yizhao, 2025). According to the provisions of the “Nine People’s Guidelines”, the review should be conducted in accordance with the mandatory regulations on profit distribution. In other words, cash compensation needs to be carried out through the target company in the form of profit distribution. In fact, when it comes to cash compensation, the investors are confronted with two predicaments: First, the company has no profits available for distribution. Generally speaking, when investors demand cash compensation, it is often because the company fails to reach the agreed profit or fails to successfully complete the listing, etc. Under such circumstances, the company is actually in operational difficulty, and there is no profit to be divided on the books. Second, the company has profits available for distribution, but it is difficult to achieve. Targeted profit distribution not only requires the board of directors to formulate a profit distribution plan, but also needs the shareholders’ meeting to reach a unanimous resolution on it. In terms of substantive conditions, a limited liability company can only determine its own dividend rules with the unanimous consent of all shareholders, while a joint stock limited company needs to separately meet the recommendations of its articles of association.

When the compensation subjects are the shareholders of the target company, they still face difficulties: First, the shareholders’ ability to fulfill their obligations is weak. If shareholders do not reserve sufficient cash or liquid assets, especially when the amount of the bet is large, they may be unable to pay the compensation. Even if the court rules in favor, the enforcement stage may still reach a deadlock due to shareholders having “no assets available for enforcement”. Furthermore, shareholders may transfer assets in advance through divorce, gifts, related-party transactions, and other means, resulting in the failure of execution. If no guarantee measures (such as equity pledge and property preservation) are set in the agreement, it will be difficult for investors to recover. Second, deviating from the investor’s goals. If the compensation involves equity transfer, other shareholders may exercise the preemptive right, forcing the investor to accept non-cash compensation (such as discounted equity), deviating from the original agreement objective.

## 3 Strategies for Dealing with Difficulties in the Performance of Put Option Agreements

### 3.1 Take Precautions

#### 3.1.1 Information Disclosure

In the new Company Law, shareholders’ right to know is stipulated in Article 57, but creditors’ right to know is rarely involved. The creditor and the company often establish the creditor’s debt relationship based on the company’s registered and publicized information, but the lag and limitation of the publicized information may affect the creditor’s judgment (Yue Wanbing, 2023). It leads to the loss of creditors’ interests. The investor signs a betting agreement with the target company. After the investor performs the betting agreement, the capital of the company increases, and creditors

lend funds based on the company's solvency, but they may not know the compensation terms, which leads to the creditors' misjudgment.

When financing, the company shall inform creditors of the existence of the gambling agreement, so as to remind creditors that the company's capital may decline in the future due to the failure of gambling, and alleviate the increased risk of creditors due to "information distortion" (Zhu Qing & Tong Chuanyu, 2024). At this time, the investor who knows the existence of the compensation agreement is still willing to reach an agreement with the company, and should bear the risk when the bet fails, and cannot prevent the capital reduction procedure. It should be noted that the object of disclosure of the company's information is only the creditor established during the performance of the gambling agreement. Because the creditors in this period may be optimistic about the company's asset status due to the information deviation caused by the internal nature of the gambling agreement, they may misjudge.

### 3.1.2 Company Resolution

The signing of the betting agreement is to increase the capital, and the share buyback is to reduce the capital, which needs to pass the special resolution of the shareholders' meeting. According to Section 116 of the Companies Act 2023, a resolution of the shareholders' meeting to increase or decrease the registered capital shall be passed by more than two-thirds of the voting rights held by the shareholders present at the meeting. When the betting agreement is signed, the interests of the investor, the company, and all shareholders are consistent, and the investor aims to achieve excess returns through the growth of the company or market expansion, and then pursues capital appreciation. The company aims to obtain capital injection seeks to expand production and sustainable development. Shareholders enjoy the capital dividend provided by the investor, and the capital increase resolution is easy to pass. However, after the failure of the bet, the capital reduction resolution of the share buyback is difficult to reach. At this time, the investor requires the company to buy back the shares according to the gambling agreement; Share buybacks will lead to a reduction in company capital, even bankruptcy; Share buybacks result in less money controlled by shareholders. The interests of the investor, the company, and the shareholders are contradictory, and the capital reduction procedure requires the company to pass a special resolution. The shareholders often use the capital reduction procedure to fight the investor, which makes the gambling agreement difficult to perform.

When a capital increase resolution is formed, a conditional capital reduction resolution is also formed. First, it can clear the obstacles to capital reduction after the failure of gambling. At the objective level, after the gambling fails, the conditional capital reduction resolution takes effect automatically, so as to avoid the shareholders' malicious use of the capital reduction procedure to hinder the performance of the gambling agreement. At the subjective level, the capital increase resolution and the conditional capital reduction resolution are parallel, and the shareholder resistance is small, because at the time of signing the gambling agreement, the shareholders, the company, and the investors are often positive about the future development of the company. Second, it can save the cost of company meetings and shareholder meetings. Capital increase and capital reduction resolutions involve major matters of the company, convening shareholders, booking venues, etc., which will cost the company's manpower, material resources, and financial resources. Shareholders attending the meeting will also incur transportation expenses, time, etc. Taking both decisions together can reduce the cost of meetings between the company and its shareholders.

### 3.1.3 Third-party Acquisition

Paragraph 2 of Article 5 of the "Nine People's Records" requires capital reduction before repurchase, which actually

indicates that the target company can use the funds released through the capital reduction procedure as repurchase funds for the target company to repurchase the investor's equity (Zhai Wenzhe & Zhang Yanhong, 2021). First of all, the share buyback in the betting agreement may lead to the decline of the company's capital, unable to operate normally, and more seriously, make the company insolvent and go bankrupt. Secondly, according to Article 224 of the Company Law, when the company makes a capital reduction resolution, it shall notify the creditors, and the creditors have the right to require the company to pay off its debts or provide corresponding guarantees. If creditors choose to require the company to pay off its debts in advance, it may cause the company's cash flow to break, resulting in bankruptcy. Finally, the reduction of the company's capital and the decline of its solvency will also affect the realization of creditors' claims.

In this regard, at the time of signing the betting agreement, the target company and the investor can introduce a third party as a party to the agreement. When the bet fails, the third party has the obligation to purchase the investor's equity, so as to maintain the capital of the target company and remove the obstacles of the capital reduction procedure for the performance of the bet agreement. The third party in the gambling agreement has the nature of guarantee, guaranteeing the target company to successfully perform the agreement, otherwise bearing the obligation of equity acquisition.

### 3.2 After-action Relief—Solvency Test

Share repurchases do not necessarily have an adverse effect on the company and its creditors. When the existing capital of the company can still maintain the operation of the company after the share repurchase, and the assets are greater than the liabilities, the share repurchase does not affect the interests of the company and its creditors. For this reason, China can refer to the solvency test in the Model Business Company Law of the United States. The test usually consists of three sub-tests: the balance sheet test, the liquidity test, and the significant asset deficiency test. Among them, the balance sheet test focuses on the company's solvency at the time of liquidation; The test of equity solvency focuses on the solvency in the sense of corporate liquidity. At the heart of the significant asset deficiency test is whether a share buyback would result in a company with unreasonably small assets that would make it impossible to sustain operations (Bao Kangyun, 2024).

When the company passes the solvency test, but the shareholder intentionally obstructs the capital reduction procedure, the court may find that the company's intentional inaction constitutes a breach of contract and order it to bear the liability for compensation. And when the company fails the solvency test, or shareholders reject the capital reduction process on the basis of autonomy<sup>1</sup>, This is a commercial risk<sup>2</sup>, The company does not constitute a breach of contract and does not bear the corresponding responsibility, and the investor shall claim rights to the court again until the company recovers its financial condition or the capital reduction resolution is passed.

In general, the execution of the capital reduction procedure involves the internal management of the company, and the judiciary cannot force the company to form a capital reduction resolution. However, the parties to the gambling agreement can break the procedural obstacles of capital reduction by disclosing information to creditors, forming a conditional capital reduction resolution, and agreeing to a third party to purchase equity; After the failure of the bet, the investor shall be relieved according to the test result of the company's solvency.

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<sup>1</sup> In the absence of corresponding legal and regulatory basis, the judiciary shall not intervene in the internal governance of a company.

<sup>2</sup> According to the content of the put option agreement, the investor can obtain asset appreciation if the put option is successful, and can recover the capital injection and receive compensation if the put option fails. Based on the advantageous interest position of the investor, it should bear the corresponding commercial risks.

## 4 Conclusion

The performance predicament of the put option agreement is essentially a conflict between the principle of capital maintenance and the commercial autonomy of will. Against the backdrop of the new Company Law strengthening the protection of creditors, this contradiction has become increasingly prominent. This article, by sorting out the evolution of judicial judgment rules and the constraints of the current legal framework, reveals the practical obstacles of the put option agreement in equity repurchase and cash compensation: The strictness of the capital reduction procedure makes targeted repurchase difficult to implement, and the restrictions of profit distribution rules and shareholders' ability to fulfill their obligations make cash compensation become a "paper right". These predicaments not only affect the realization of the investors' rights and interests but may also intensify the opposition of interests in corporate governance.

To solve the above-mentioned problems, this paper proposes countermeasures from the dual perspectives of system improvement and protocol design. On the one hand, strengthening the obligation of information disclosure and the advance arrangement of conditional capital reduction resolutions can effectively alleviate the procedural deadlock. The introduction of the third-party acquisition mechanism provides an alternative path for equity repurchase and avoids excessive consumption of the target company's capital. On the other hand, drawing on the "solvency test" standards from abroad and focusing judicial review on the company's debt-paying ability can not only safeguard the interests of creditors but also provide a basis for relief for investors. These suggestions not only conform to the legislative spirit of the new "Company Law" but also provide operational judgment criteria for judicial practice.

However, this study still has certain limitations. First of all, the performance of the put option agreement is highly dependent on individual case situations. The strategies proposed in this paper need to be flexibly applied in combination with specific cases. Secondly, the judgment rules of the "Nine People's Court Opinions" have not yet been fully transformed into judicial interpretations, and their legal effect is uncertain. Finally, the feasibility of the third-party acquisition mechanism depends on the bargaining power of market entities, which may increase the financing costs of small and medium-sized enterprises. Future research can further explore the interactive effect between put option agreements and corporate governance structures, as well as the innovative models of put option clauses in the digital age.

Overall, the regulation of put option agreements needs to seek a dynamic balance among protecting creditors, balancing the interests of shareholders, and respecting commercial innovation. With the deepening development of China's capital market, improving the legal framework of the put option agreement and strengthening the risk allocation mechanism in advance will become important issues for optimizing the business environment and stimulating the vitality of enterprises.

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